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*Treatment of Seller-Funded Downpayment Assistance in  
FHA-Insured Home Loans*

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**Abstract.** In order to qualify for FHA-insured home loans, borrowers are required to contribute a minimum amount to the cost of purchasing the home. Under certain conditions the borrower's required contribution may be paid by others. Can the borrower's required contribution be paid by a nonprofit agency that is later reimbursed by the seller of the property? That has been the subject of regulation, litigation, and legislation. The Housing and Economic Recovery Act of 2008, P.L. 110-289, effective October 1, 2008, increases the borrower's required contribution from 3% to 3.5% and provides that the borrower's required contribution towards the purchase of an FHA-insured home may not be provided by the seller or by any third party that is being reimbursed by the seller. Enactment of the law does not mean that sellers may not provide downpayment assistance to borrowers obtaining FHA-insured home loans. It will simply mean that any contribution by the sellers will not count towards the 3.5% contribution required of the borrower. Current HUD rules provide that the seller or other interested third parties may contribute up to 6% of the property's sales price toward the buyer's costs. As introduced on July 31, 2008, H.R. 6694 would amend the new law to provide exceptions to the prohibition on seller contributions. This report will be updated as suggested by changes in law or regulation.

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## CRS Report for Congress

# Treatment of Seller-Funded Downpayment Assistance in FHA-Insured Home Loans

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## Summary

In order to qualify for FHA-insured home loans, borrowers are required to contribute a minimum amount to the cost of purchasing the home. Under certain conditions the borrower's required contribution may be paid by others. Can the borrower's required contribution be paid by a nonprofit agency that is later reimbursed by the seller of the property? That has been the subject of regulation, litigation, and legislation. The Housing and Economic Recovery Act of 2008, P.L. 110-289, effective October 1, 2008, increases the borrower's required contribution from 3% to 3.5% and provides that the borrower's required contribution towards the purchase of an FHA-insured home may not be provided by the seller or by any third party that is being reimbursed by the seller. Enactment of the law does not mean that sellers may not provide downpayment assistance to borrowers obtaining FHA-insured home loans. It will simply mean that any contribution by the sellers will not count towards the 3.5% contribution required of the borrower. Current HUD rules provide that the seller or other interested third parties may contribute up to 6% of the property's sales price toward the buyer's costs. As introduced on July 31, 2008, H.R. 6694 would amend the new law to provide exceptions to the prohibition on seller contributions. This report will be updated as suggested by changes in law or regulation.<sup>1</sup>

## The Housing and Economic Recovery Act of 2008

Under the Housing and Economic Recovery Act of 2008, P.L. 110-289, as enacted on July 30, 2008, borrowers will be required to contribute at least 3.5% in cash or its equivalent to the cost of acquiring a property with an FHA-insured mortgage. Amounts borrowed from a family member will be considered as cash for this purpose. Prohibited sources of funding for the required funds will be the seller or any entity that financially

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<sup>1</sup> For information on the FHA mortgage insurance program, please see CRS Report RS20530, *FHA Loan Insurance Program: An Overview*, by Bruce E. Foote and Meredith Peterson.

benefits from the transaction, or any third party that is directly or indirectly reimbursed by the seller or by anyone that would financially benefit from the transaction. The law is in effect for transactions entered into on or after October 1, 2008.

Enactment of the law does not mean that sellers may not provide downpayment assistance to borrowers obtaining FHA-insured home loans. It will simply mean that any contribution by the sellers will not count towards the 3.5% contribution required of the borrower. As noted below, current HUD rules provide that the seller or other interested third parties may contribute up to 6% of the property's sales price toward the buyer's actual closing costs. Nonprofits may still provide gifts that would pay borrowers' required contributions, but the source of these gifts may not be the sellers. This might have negative consequences on those nonprofits whose primary function was to act as middlemen in providing assistance to borrowers that would otherwise be prohibited by HUD rules.

## Present Regulation

Except for veterans or for borrowers replacing homes that have been damaged or destroyed by presidentially-declared disasters, the HUD regulation provides that borrowers are required to contribute at least 3% in cash or its equivalent of the cost of purchasing a home when the home is financed with an FHA-insured loan.<sup>2</sup> The regulation provides that, for borrowers aged 60 or more, or for certain homes provided through the Homeownership and Opportunity Through HOPE Act<sup>3</sup> (42 U.S.C. 1437aaa), the 3% contribution may be obtained through a loan from a corporation or other person under terms and conditions prescribed by HUD. For veterans or for borrowers replacing homes that have been damaged or destroyed by presidentially-declared disasters, only a \$200 investment is required.<sup>4</sup> The regulation is silent regarding prohibited sources of funding.

## Administrative Provisions

Revision 5 (REV-5) of HUD Handbook 4155.1 contains the underwriting guidelines for single family mortgage loans insured under the National Housing Act.<sup>5</sup> Although the regulation and prior law were silent regarding prohibited sources of funding for the

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<sup>2</sup> 24 CFR 203.19. This is based on prior law. Note that the law is amended to require a 3.5% contribution, and the regulation will likely be updated to reflect this change.

<sup>3</sup> Title IV of the Cranston-Gonzalez National Affordable Housing Act, P.L. 101-625. The title authorizes HUD to make grants under the Homeownership and Opportunity for People Everywhere (HOPE) programs to enable grantees to carry out homeownership programs in public and Indian housing and in other multifamily housing projects.

<sup>4</sup> Please note that this description is based on the regulation as published on April 1, 2007, which differs from the regulation as published on April 1, 2008. As will be discussed below, the 2008 version of the regulation includes language from an amended regulation published on October 1, 2007, but the October regulation has been set aside by the court and remanded to HUD for further action. This likely means that the 2008 version of the regulation is not in effect.

<sup>5</sup> Mortgage Credit Analysis for Mortgage Insurance, One to Four Family Properties, Handbook 4155.1 REV-5, October 2003. [<http://www.hud.gov/offices/adm/hudclips/handbooks/hsggh/4155.1/41551HBHSGH.pdf>]

borrower's required contribution, the Handbook establishes that HUD does not permit the contributions to be made by the sellers of the property.<sup>6</sup>

Handbook 4155.1 REV-5 provides that the seller or other interested third parties such as real estate agents, builders, developers, or a combination of parties, may contribute up to 6% of the property's sales price toward the buyer's actual closing costs, prepaid expenses, discount points, and other financing concessions.<sup>7</sup> These provisions may be included in the sales contract negotiated between buyers and sellers by the real estate agents.

Though the Handbook permits third parties to make contributions towards the buyer's costs, the Handbook repeats the provisions of the regulation regarding the 3% required contribution from the borrower. Contributions from third parties do not count towards the buyer's required contribution. The Handbook states, however, that an outright gift of the required cash investment is acceptable if the donor is (1) the borrower's relative, (2) the borrower's employer or labor union, (3) a charitable organization, (4) a government agency or public entity that has a program to provide homeownership assistance to low- and moderate-income families or first-time homebuyers, or (5) a close friend with a clearly defined and documented interest in the borrower.<sup>8</sup>

The Handbook goes on to state that the donor may not be anyone with an interest in the sale of the property, such as the seller, real estate agent, builder, or any entity associated with the above. HUD considers gifts from these sources to be inducements to purchase, and the amount of the gift must be subtracted from the sales price and this reduces the maximum loan that FHA will insure on that property.

An FHA-insured loan on which the buyer has received a gift of the required funds must be documented with a so-called "gift letter." The letter must meet certain requirements: (1) be signed by the donor and the borrower; (2) specify the amount of the gift; (3) state that no repayment is required; (4) show the name, address, and phone number of the donor; and (5) state the nature of the relationship between the donor and borrower.

## **Downpayment Assistance Programs Sponsored by Nonprofits**

As noted above, Handbook 4155.1 REV 5 provides that borrowers must contribute at least 3% toward the purchase of the home, and that a nonprofit may provide a gift of the required contribution as long as the funds are not provided by the sellers. In the 1990s, several nonprofits developed a form of seller-funded downpayment assistance (DPA) program that worked around this HUD restriction on seller funding. The seller-funded DPA programs were structured as follows: (1) the nonprofit would provide the borrower with a gift of the required funds; (2) after completion of the home sale, the seller of the home would make a donation to the nonprofit; and (3) the amount of the donation

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<sup>6</sup> Handbook 4155.1 REV 5, p. 1-8.

<sup>7</sup> Handbook 4155.1 REV 5, p. 1-8.

<sup>8</sup> HUD Handbook 4155.1 REV-5, p. 2-24.

would be the amount the nonprofit had paid on behalf of the borrower plus a processing fee for the nonprofit.

Since the borrower's costs had already been paid by the nonprofit, technically, the contribution from the seller was not paying that borrower's costs, it was replenishing the funds of the nonprofit and enabling the nonprofit to contribute to the downpayment of some future borrower. Structured in this manner, the transaction did not appear to be prohibited by HUD's policy against having the borrower's required contribution paid by the sellers.

HUD, however, did not agree with this interpretation. The Nehemiah Progressive Housing Development Corporation (Nehemiah) of Sacramento, CA, was given approval of its DPA program by a local HUD office. The HUD national office reviewed the paperwork and concluded that gifts to borrowers by Nehemiah would no longer be counted as meeting the borrower's contributions. Nehemiah filed a suit over HUD's decision.<sup>9</sup> A settlement agreement was reached in 1998 whereby Nehemiah was permitted to continue operation of its DPA program; and HUD reserved the right to take regulatory actions with regard to DPA programs. The agreement also provided that if HUD took regulatory action regarding HUD's treatment of DPA providers, the applicability of the changes to Nehemiah would occur six months from the effective date of the new rule.

The Nehemiah Program has expanded nationally and become the largest provider of downpayment assistance for borrowers obtaining FHA-insured home loans. A number of other nonprofit organizations have followed the Nehemiah pattern and offer similar downpayment assistance programs.

## Current Issues with Downpayment Assistance

**IRS Ruling.** In May 2006, the Internal Revenue Service (IRS) published Revenue Ruling 2006-27, which provides guidelines on organizations that may provide downpayment assistance to homebuyers and qualify as tax-exempt charitable or educational organizations under Internal Revenue Code (IRC) section 501(c)(3), and those that do not qualify for this tax-exempt status. In its press announcement of the ruling, the IRS stated that funneling downpayment assistance from sellers to buyers through 'self-serving, circular-financing arrangements' is inconsistent with operation as a section 501(c)(3) charitable organization.<sup>10</sup>

The ruling provides that an organization providing downpayment assistance does not qualify as a 501(c)(3) organization if: (1) to finance its downpayment assistance activities, the organization relies on sellers and other real-estate related businesses that stand to benefit from the transactions the organization facilitates; (2) in deciding whether to provide assistance to a low-income applicant, the organization's staff knows the identity of the home seller and may also know the identities of other interested parties and is able to take into account whether the home seller or another interested party is willing to make a payment to the organization; (3) the organization's receipt of a payment from the home

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<sup>9</sup> Nehemiah Progressive Housing Corp. v. Andrew Cuomo, et al., Civ. S-97-1817-GEB/PAN (E.D. Cal.).

<sup>10</sup> [<http://www.irs.gov/newsroom/article/0,,id=156675,00.html>]

seller is corresponding to the amount of the downpayment assistance in substantially all of the transactions; (4) the organization's reliance on these payments for most of its funding indicates that the benefit to the home seller is a critical aspect of the organization's operations; (5) the organization is structured and operated to assist private parties who are affiliated with those who fund the organization.<sup>11</sup>

The IRS noted that it is examining 185 organizations that operate downpayment assistance programs. In addition, the agency noted that it has denied applications for tax exemption from over 20 organizations that seek to provide this service.

**Revisions to the HUD Regulations.** Over the years, thousands of families have become homeowners through FHA-insured loans using Nehemiah-type DPA programs. Proponents of the programs point to these numbers and argue that, without cost to the taxpayers, the programs have been able to provide homeownership opportunities to low- and moderate-income families.

HUD argues, however, that the success of these seller-funded DPA programs has not come without cost. HUD suggests that the programs have provided homeownership but they have not provided sustainable homeownership in too many cases.<sup>12</sup> HUD notes that the rates of defaults, foreclosures, and claims have increased so dramatically that the seller-funded DPAs jeopardize the solvency of the FHA insurance fund.<sup>13</sup>

Losses to the insurance fund could possibly be sustained if mortgages involving seller-funded DPAs were a small part of the insurance pool. But borrowers receiving gifts of the required funds have increasingly become a larger part of the FHA insurance pool. In FY1996, borrowers who received gifts were 29% of FHA-insured loans. By FY2006 such borrowers had grown to nearly 42% of FHA-insured loans.<sup>14</sup> About 50% of the gifts received by borrowers in FY2006 and FY2007 were those from the sellers of the property.<sup>15</sup> HUD finds the default rate on loans with gifts from sellers to be nearly twice the default rate on loans with gifts from family members.<sup>16</sup>

A primary concern of HUD is that the sales price is often increased on homes financed through seller-funded DPA programs. Inflated sales amounts result in inflated mortgage amounts, and this increases the size of claims against the FHA insurance fund when the loans default.<sup>17</sup> For these reasons HUD has sought to curtail the seller-funded DPA programs.

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<sup>11</sup> IRS Revenue Ruling 2006-27 at [<http://www.irs.gov/pub/irs-drop/rr-06-27.pdf>].

<sup>12</sup> 72 FR 27047.

<sup>13</sup> 73 FR 33942.

<sup>14</sup> FHA's Quarterly Report to the Commissioner on FHA Business Activity, September 2007, p. 10.

<sup>15</sup> An Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund, prepared for the U.S. Department of Housing and Urban Development by Integrated Financial Engineering, Inc., October 12, 2007, p. 68.

<sup>16</sup> 73 FR 33952.

<sup>17</sup> 72 FR 27049.

On May 11, 2007, HUD published a proposed rule to establish that a prohibited source of downpayment assistance is a payment that consists, in whole or in part, of funds provided by any of the following parties before, during, or after closing of the property sale: (1) the seller, or any other person or entity that financially benefits from the transaction; or (2) any third party or entity (referred to as a ‘donor’) that is reimbursed directly or indirectly by any of the parties listed in clause (1).<sup>18</sup> Only organizations that qualify as tax-exempt charitable or educational organizations under Internal Revenue Code Section 501(c)(3) would be eligible donors. This regulation was made final on October 1, 2007, and had an effective date of October 31, 2007.<sup>19</sup> For Nehemiah, the effective date was March 31, 2008, because of the terms of the 1998 settlement agreement between Nehemiah and HUD.

Nehemiah and several other organizations, whose nonprofit status might be challenged by the IRS, filed suit to block HUD’s implementation of this new rule. The United States District Court for the District of Columbia issued a ruling on November 1, 2007, temporarily enjoining HUD from implementing the downpayment assistance rule. On March 5, 2008, the court vacated the final rule and remanded it to HUD for further processing consistent with the court’s opinion.<sup>20</sup>

On June 16, 2008, HUD published a new proposed rule which reopens the comment period on the May 7, 2007 proposed rule, as revised by the October 1, 2007 rule.<sup>21</sup>

## Current Legislation

As introduced on July 31, 2008, H.R. 6694 would amend the new law to provide exceptions to the prohibition on seller contributions. Sellers would be permitted to contribute to the borrower’s required funds on certain mortgages: (1) mortgages under which the borrower has a credit score in excess of 680; (2) mortgages under which the borrower has a credit score between 620 and 680, and upon which the borrower is charged a mortgage insurance premium that is high enough to permit the loan to be insured without the need for an appropriation of credit subsidy; and (3) mortgages insured in FY2010 or thereafter under which the borrower has a credit score of 619 or less, but only if HUD certifies that such loans can be insured without the need for an appropriation of credit subsidy. HUD would be authorized to use risk-based pricing of mortgage insurance for borrowers with lower credit scores. Downpayment assistance entities would be required to offer to make counseling available to the borrower regarding the responsibilities and financial management involved in homeownership and to provide such counseling if the borrower accepts the offer.

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<sup>18</sup> 72 FR 27047.

<sup>19</sup> 72 FR 56002

<sup>20</sup> *Ameridream Inc., et al. v. Jackson*, No. 07-1752 (D.D.C. March 5, 2008) and *Penobscot Indian Nation, et al. v. HUD*, No. 07-1282-PLF (D.D.C. March 5, 2008).

<sup>21</sup> 73 FR 33942.